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NOTEWORTHY DECISIONS IN THE LAW OF PRIVATE CORPORATIONS: 1940-1945

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With respect to lawyer-veterans my experience convinces me that the activities of war do not obliterate legal knowledge. The problem of the individual returning lawyer is more likely to be one of morale, and for this, interesting and remunerative legal work is a far more effective antidote than any kind of "refresher" course. In short, I do not believe that the lawyer-veterans need to be crammed with legal learning through the medium of a series of lectures or articles which undertake to survey in summary fashion the major topics of the law.

But there is one element of the war-time gap in the professional life of a general practitioner with respect to which persons having an expert knowledge of various fields of law can be of help. One of the distinguishing marks of a profession is the self-education to which its practitioners forever continue to subject themselves despite the successful completion of their formal studies. For thousands of lawyers the war years brought about a hiatus in this process of self-education, and to them it ought to be of value at least to have their attention directed to various segments of the war-time case-law which in normal times they would have absorbed for themselves. To contribute in part to such an endeavor is the primary object of this article.¹

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1. This article will be published by the Practising Law Institute. I wish to express my thanks to Russell R. Levin and Morris L. Weisberg, both of whom are students at the University of Pennsylvania Law School, for their help in the preparation of the case material upon which this article is based. I also wish to acknowledge my great indebtedness to Alice H. Frey, without whose constant aid and counsel this article could not have been completed.

Within the field of private corporations I have tried to be of maximum service to the returning practitioner by not merely supplying him with accurate citations to the war-time decisions;² I have also undertaken to separate the grain from the weeds by centering attention upon those cases which my experience indicates to be the most significant; finally, I have prepared a factual outline of the matters involved in these significant cases, have classified the cases under each division or subdivision of this outline, and have discussed many of the topics in the outline. I shall be much surprised if those for whom this article is primarily intended do not find its major value in the outline. The italicized headings in the following pages are the main divisions of the outline; its more detailed subdivisions and the classification of the cases thereunder are indicated in the footnotes.

I hope that the reader will not be disappointed because I rejected the idea of building the article around a series of statements of the significant cases. I ultimately concluded that a parade of such briefs would add very little to the value of the outline, for any lawyer with a related problem would undoubtedly realize the desirability of reading the cases in point themselves instead of relying upon someone else's summary.

Corporate Managers' Profits

The significant cases of the war period were concerned with seven types of situations in which corporate officials profited or were alleged to have profited at the expense of the corporation or its shareholders.³

2. It should not be overlooked that the corporate problems herein presented are not war products. The war merely determines the period covered. Most of the cases concern situations which had in fact arisen prior to the war; many of them are but the culmination of suits instituted during a nominally peaceful era.

3. (1) Appropriation of corporate property:

Gochenour v. George and Francis Ball Foundation, 35 F. Supp. 508 (D. C., S. D. Ind., 1940), *aff'd* 117 F. (2d) 259 (C. C. A. 7th, 1941); noted in 27 VA. L. R. 702 (1941).

Piccard v. Sperry Corp., 36 F. Supp. 1006 (D. C., S. D. N. Y., 1941), *aff'd* 120 F. (2d) 328 (C. C. A. 2d, 1941).

Piccard v. Sperry Corp., 48 F. Supp. 465 (D. C., S. D. N. Y., 1943), *aff'd* 152 Fed. (2d) 462 (C. C. A. 2d, 1946); noted in 43 COL. L. R. 382 (1943).

Bainbridge v. Stoner, 16 Calif. (2d) 423, 106 Pac. (2d) 423 (1940); noted in 30 CALIF. L. R. 589 (1942).

Chaunis v. Laing, 125 W. Va. 275, 23 S. E. (2d) 628 (1942); noted in 49 W. VA. L. Q. 176 (1943).

(2) Increase of own compensation:

Winkelman v. General Motors Corp., 39 F. Supp. 826 (D. C., S. D. N. Y., 1940), 44 F. Supp. 960 (D. C., S. D. N. Y., 1942), 48 F. Supp. 490 (D. C., S. D. N. Y., 1942); noted in 41 MICH. L. R. 501 (1942). See also Mallery v. Managers' Securities Co., 1 F. Supp. 942 (D. C., D. Del., 1932), reversed in 77 F. (2d) 186 (C. C. A. 3rd, 1935).

Holthusen v. Edw. G. Budd Mfg. Co., 52 F. Supp. 125 (D. C., E. D. Pa., 1943), 53 F. Supp. 488 (D. C., E. D. Pa., 1943); noted in 32 CALIF. L. R. 88 (1944).

With respect to the matter of direct appropriation of corporate property (which, after all, is in fact theft), there is little that can be said by one who is against sin. The issues presented by the cases are seldom purely factual even at the trial court level. The defendant does not content himself with merely denying that he did the acts ascribed to him. Nor does he rely upon an assertion by way of demurrer that the acts charged, even if true, do not establish any legal culpability on his part. Most frequently the action is a shareholder's representative suit,⁴ and the most common defense is a counterattack upon the legal capacity of the complaining shareholder to maintain the action.⁵

- (3) Sale of corporate "control":
Insuranshares Corp. v. Northern Fiscal Corp., Ltd. et al., 35 F. Supp. 22 (D. C., E. D. Pa., 1940), 42 F. Supp. 126 (D. C., E. D. Pa., 1941); noted in 26 CORN. L. Q. 325 (1941), 54 HARV. L. R. 648 (1941), 39 MICH. L. R. 650 (1941), 25 MINN. L. R. 525 (1941), 27 VA. L. R. 546 (1941).
Levy v. American Beverage Co. et al., 29 N. Y. Supp. (2d) 550 (1941), *rev'd* 265 App. Div. 208, 38 N. Y. Supp. (2d) 517 (1942); noted in 16 TEMP. L. Q. 232 (1942).
Gerdes v. Reynolds, 28 N. Y. Supp. (2d) 622 (1941), 28 N. Y. Supp. (2d) 668 (1941), 30 N. Y. Supp. (2d) 755 (1941); noted in 26 MINN. L. R. 118 (1941).
Miller v. Vanderlip, 285 N. Y. 116, 33 N. E. (2d) 51 (1941); noted in 54 HARV. L. R. 1398 (1941).
- (4) Use of interlocking management to benefit one of the corporations:
Everett v. Phillips et al., 288 N. Y. 227, 43 N. E. (2d) 18 (1942); noted in 11 FORDHAM L. R. 311 (1942).
Blaustein v. Pan American Petroleum Co. et al., 174 Misc. 601, 21 N. Y. Supp. (2d) 651 (1940), 263 App. Div. 97, 31 N. Y. Supp. (2d) 934 (1941), 293 N. Y. 281, 763, 56 N. E. (2d) 705, 57 N. E. (2d) 841 (1944); noted in 51 YALE L. J. 1034 (1942).
- (5) Secret profits from transaction with the corporation:
Fleishhacker et al. v. Blum et al., 21 F. Supp. 527 (D. C., N. D. Calif. S. D., 1937), 109 F. (2d) 543 (C. C. A. 9th, 1940), *cert. denied* 311 U. S. 665, 61 Sup. Ct. 23 (1940); noted in 39 MICH. L. R. 314 (1940). See also *Denicke v. Anglo California Nat. Bank et al.*, 45 F. Supp. 524 (D. C., N. D. Calif. S. D., 1942).
Bay City Lumber Co. v. Anderson, 8 Wash. (2d) 191, 111 Pac. (2d) 771 (1941); noted in 30 CALIF. L. R. 195 (1942).
- (6) Profiting from transaction potentially beneficial to the corporation:
Brainard v. De La Montanya, 18 Calif. (2d) 502, 116 Pac. (2d) 66 (1941); noted in 30 CALIF. L. R. 193 (1942).
Lincoln Stores, Inc. v. Grant, 309 Mass. 417, 34 N. E. (2d) 704 (1941); noted in 55 HARV. L. R. 866 (1942).
 [For a leading pre-war decision see *Irving Trust Co. v. Deutsch*, 73 F. (2d) 121 (C. C. A. 2d, 1934), reversing in part 2 F. Supp. 971 (D. C., S. D. N. Y., 1932), *cert. denied* 294 U. S. 708, 55 Sup. Ct. 405, 79 L. Ed. 1243 (1935).]
- (7) Non-disclosure of facts in dealing with own shareholder:
American Trust Co. v. Calif. Western States Life Ins. Co., 76 Pac. (2d) 201 (1938), *aff'd* 99 Calif. 71, 98 Pac. (2d) 497 (1940); noted in 29 CALIF. L. R. 67 (1940). See also *Calif. Western States Life v. Pac. Am. Co.*, 76 Pac. (2d) 209 (1938), *aff'd* 15 Calif. (2d) 763, 98 Pac. (2d) 511 (1940) and *Same v. Tucker*, 76 Pac. (2d) 209 (1938), *aff'd* 15 Calif. (2d) 69, 98 Pac. (2d) 511 (1940).

4. The term "representative suit" is herein used to refer to an action instituted by a shareholder to enforce a claim of his corporation which the corporate officials have neglected or refused to enforce; the term "derivative suit" is employed by some writers to describe an action of this character

5. See *infra*, pages 274-277.

The use by the erring corporate official of a separate corporate entity in an effort to conceal his fraud is not uncommon. But in no situation are the courts more willing to pierce the corporate veil. When the wrongdoer is discovered he frequently resorts to another protective device: he induces the directors and the holders of a majority of the shares to agree to a settlement, favorable to himself, of the corporation's claim against him. But an alert court will hold that the corporate directors and majority shareholders acting in conjunction have no more power effectively to deprive minority shareholders of their interests in particular corporate assets by simply giving said assets away than the directors have to deprive the entire body of shareholders of their interests by giving corporate property to themselves or others.

Exorbitant increases by corporate officers of their own compensation are also, to put it bluntly, a kind of thievery, for it amounts to appropriating corporate property without a fair return to the corporation. Outright salary increases are seldom the subject of litigation. It is an indirect form of compensation, such as bonus payments and stock purchase options, about which shareholders are more likely to complain to the courts. Unquestionably the case which is the most interesting war-time illustration of alleged misconduct on the part of corporate managers is that of *Winkelman v. General Motors Corporation*.⁶

Limitations of time and space do not permit of comment upon each of the topics indicated in footnote 3, but any discussion of profits of corporate managers would be seriously incomplete without some consideration of the matter of accepting bribes as an inducement either to transfer the managerial powers to others or not to exercise them in the best interests of the corporation.

The transfer of corporate management from one set of persons to another can be accomplished only by those who have "control," i. e., the legal power to select the directors and executive officers of the corporation. When such transfers become the subject of complaint, they usually prove to have been one of two types: (1) those who own a majority of or a controlling interest in the shares of the corporation transfer their shares to others who thereafter proceed to elect themselves (or their personal agents) directors and officers and to loot the corporation; (2) those who are a majority of the directors and officers enter into an agreement with others to resign one by one and to elect such others (or their nominees) as their successors under a statutory authorization to fill vacancies in the Board until the next shareholders'

6. See *supra*, note 3.

meeting, and the members of this new Board proceed to loot the corporation.

Much the same result can be accomplished without a technical transfer of management; this occurs when those constituting a majority of the existing management enter into an agreement with others to exercise their powers in a way which is or may be adverse to the best interests of the corporation.

Suits arising out of such transactions are usually actions either to make the corporate officials account to the corporation for personal gain derived by them from relinquishing management in whole or in part, or to hold them accountable for injury suffered by the corporation as a result of their alleged misconduct. Actions based upon an actual sale of a majority or controlling share interest are somewhat less likely to succeed than actions based upon a "sale" by those who manage the corporation of their managerial powers. In the former actions the outcome is determined largely by three factors: (a) the relation between the fair market value and the price received by the shareholders upon the transfer of their block of shares; (b) the extent to which the transferors also exercised managerial functions; and (c) the awareness of the transferors of the marauding plans of their transferees. Such suits do succeed, however, with sufficient frequency to expose the dubiety of the dogma that shareholders are in no sense trustees for one another.

Bribery of corporate officials is not confined to sales of "control." The use of interlocking corporate managements for the primary benefit of one of the corporations is in any event a fraud on the injured corporation, and if the common officers profit personally from the benefit to the favored corporation, which is frequently the case, it is also a species of bribery, for the officers in question have been lured by the prospect of personal gain into betraying one of the corporations they represent. The deriving by a corporate manager of a secret profit from a transaction with his own corporation is a more subtle form of bribery, a self-inducement not to exercise his managerial powers in the best interests of the corporation.

When a corporate manager derives personal gain from a transaction which would have been beneficial to his corporation, had the opportunity been made available to it, he may or may not be exploiting a situation which he should have diverted to the corporation. Whether or not such transactions involve a breach of trust is admittedly a border-line problem, but, despite some decisions to the contrary, there is, I believe, an increasing tendency of the courts to resolve the doubt in favor of the corporation.

Corporate Managers' Neglect of Duty

There are many derelictions of duty with which corporate directors and other officials may be charged, and five of these are exemplified in the significant war-time decisions.⁷

Save for a few exceptional circumstances,⁸ a corporation is generally forbidden by the law of the state of its incorporation to surrender to its shareholders any portion of the value which they contributed to the corporation in return for their shares. The basis for this requirement is two-fold: first, to preserve the shareholders' interest in the scope of the enterprise, and secondly, to afford a margin of protection for the creditors, in view of the limited liability of the shareholders, by insistence upon the maintenance, except for operating losses, of a stipulated excess of the corporation's assets over its liabilities to its creditors. It is for these reasons that corporate statutes invariably indicate in some manner the fund from which dividends may lawfully be paid, and that the common law similarly limits the privilege of the corporation to buy back shares issued by it.

Such statutes are not uniform in their terms but they commonly provide either that a corporation may pay dividends only out of "surplus" or, conversely, that dividends may not be paid out of "capital."⁹ To induce compliance the statutes generally provide further that the directors authorizing a forbidden dividend or other distribution of corporate assets shall be liable either to the corporation to the amount

7. (1) Wrongful payment of dividends:

Aiken et al. v. Insull et al., 122 F. (2d) 746 (C. C. A. 7th, 1941); noted in 36 ILL. L. R. 898 (1942).

Randall v. Bailey, 23 N. Y. Supp. (2d) 173 (1940), *aff'd* 262 App. Div. (2d) 844, 29 N. Y. Supp. (2d) 512 (1941), *aff'd* 288 N. Y. 280, 43 N. E. (2d) 43 (1942); noted in 54 HARV. L. R. 505 (1941), 18 N. Y. U. L. Q. 262 (1941), 89 U. OF PA. L. R. 822 (1941).

Scullin v. Mutual Drug Co., 138 Ohio St. 132, 33 N. E. (2d) 992 (1941); noted in 8 OHIO ST. L. J. 97.

(2) Purchase by corporation of its own shares:

Hayman v. Morris, 36 N. Y. Supp. (2d) 756 (1942); noted in 56 HARV. L. R. 645 (1943).

(3) Incurring corporate indebtedness in excess of permitted amount:

Warren et al. v. Adams et al., 187 Okla. 643, 105 Pac. (2d) 221 (1939); noted in 7 U. CHI. L. R. 721 (1940).

Royer v. Maib, 6 Wash. (2d) 286, 107 Pac. (2d) 335 (1940); noted in 27 WASH. L. R. 116 (1942).

(4) Issuing false financial statement:

Commercial Bank v. Weidman et al., 301 Mich. 405, 3 N. W. (2d) 323 (1942); noted in 5 U. DET. L. J. 191 (1942).

(5) Extending preference to favored creditor:

Saracco Tank & Welding Co. v. Platz, 65 Cal. App. (2d) 306, 150 Pac. (2d) 918 (1944); noted 32 CALIF. L. R. 433 (1944).

8. The principal exceptions are paid-in surplus, depletion in the case of a "wasting assets" corporation, redemption of duly authorized redeemable shares, and statutory reduction of capital stock.

9. Some statutes illogically permit the payment of dividends out of net earnings of the current fiscal period, even though a capital impairment resulting from prior losses may remain.

of the unlawful distribution, or to the corporation's creditors to the extent of any loss sustained by reason of the unlawful distribution.

Unfortunately, in many jurisdictions the applicable statutes do not indicate with adequate precision or completeness the method of ascertaining a corporation's "surplus," i. e., the portion of the corporation's assets which may properly be distributed to the shareholders either by way of dividends or by re-purchase of their shares. There is general acceptance of a concept of "surplus" as being the excess of a corporation's "total assets" over the aggregate of its "liabilities to its creditors" and its "capital." But in this formula the quoted terms are all expressed in dollars, and how to arrive at the proper dollar values is a matter upon which the statutes are significantly silent.

The courts do tend to look for "sound" accounting practices as guides, but the practices approved by accountants vary greatly, and accounting procedures have not been evolved for the express purpose of ascertaining the fund that may lawfully be distributed by a corporation to its shareholders. For example, accountants conservatively advocate that "current assets" be entered on the balance sheet at a figure representing either original cost or present market value whichever is lower, that "fixed assets" be entered at cost less depreciation, and concomitantly that appreciation in the value of an asset be not reflected until realized by a sale. The New York courts recently held, however, that no liability resulted from the fact that directors declared and paid a dividend based upon an unrealized appreciation in the value of land owned by the corporation, when the book value assigned by them to the land in determining surplus available for dividends was materially less than the actual market value though in excess of the original cost.¹⁰ The propriety of a re-purchase of shares from "appreciation surplus" has also been upheld.¹¹

Even when it is conceded that the Board of Directors authorized the payment of a dividend which resulted in a capital impairment, it does not follow that all of the directors can be subjected to liability. Some of the state statutes are explicit in exempting dissenting directors; others provide that only assenting directors may be held liable. Another defense which at times has succeeded is that the defendant directors, in declaring the improper dividend, acted in reliance upon erroneous information supplied to them by those who prepare the corporate records and accounts. Present-day courts, however, are manifesting a growing tendency to hold directors to a stricter accountability in this regard.

10. *Randall v. Bailey*, *supra*, note 7, 1.

11. *Hayman v. Morris et al.*, *supra*, note 7, 2.

For the protection of creditors statutes in a number of states provide that corporations formed therein shall not incur indebtedness in excess of the amount of the corporate capital. Such statutes also express various kinds of liabilities that may be inflicted upon directors who "authorize" violations of the debt limit. But these statutes are often loosely worded and deficient in detail. Consequently, when they are occasionally invoked against directors, the defendants are usually able to present a procedural or other technical defense. There is here a splendid opportunity for statutory analysis and for a fine piece of legislative draftsmanship, because the fundamental idea is admirable. In most states a corporation is allowed to engage in business with only a very nominal capital if it elects to do so, and the only requirement is that the stated capital, however large or small, be not impaired by distributions to the shareholders. The protection of corporate creditors, which is a primary purpose of such statutes, would be better achieved by requiring a corporation to maintain not merely a fixed amount of capital, but a stipulated relationship (perhaps on a sliding scale) between its total assets and its obligations to its creditors.

Shareholders' Representative Suits

The problems, connected with shareholders' representative suits, raised by the significant war-time decisions may be divided into seven categories.¹²

12. (1) Distinctions between shareholder's individual action and shareholder's representative suit:
Word v. Union Bank & Trust Co., 111 Mont. 279, 107 Pac. (2d) 1083 (1940), *aff'd* 112 Mont. 458, 117 Pac. (2d) 494 (1941); noted in 54 HARV. L. R. 1234 (1941).
- (2) Necessity of share ownership at time of wrong complained of:
Goldberg v. Ball et al., 305 Ill. App. 273, 271 N. E. (2d) 575 (1940); noted in 29 ILL. B. J. 221 (1941).
Klum v. Clinton Trust Co., 183 Misc. 340, 48 N. Y. Supp. (2d) 267 (1944); noted in 30 VA. L. R. 656 (1944).
Jepsen v. Peterson, 10 N. W. (2d) 749 (S. D., 1943); noted in 29 IOWA L. R. 497 (1944).
Cf. Piccard v. Sperry Corp., 30 F. Supp. 171 (D. C., S. D. N. Y., 1939) and *Pflug v. Dietz*, 260 App. Div. 503, 22 N. Y. Supp. (2d) 968 (1940); noted in 54 HARV. L. R. 1063 (1941).
- (3) Necessity of prior demand on corporate officers to sue:
Goldberg v. Ball et al., 305 Ill. App. 273, 271 N. E. (2d) 575 (1940); noted in 29 ILL. B. J. 221 (1941).
- (4) Effect of discontinuance:
Manufacturers Mutual Life Ins. Co. v. Hopson, 176 Misc. 220, 25 N. Y. Supp. (2d) 502 (1940), *aff'd without opinion* 288 N. Y. 668, 43 N. E. (2d) 71 (1942); noted in 25 MINN. L. R. 945 (1941), 50 YALE L. J. 1474 (1941).
- (5) Power of the corporation to answer:
Otis v. Pennsylvania R. R. Co., 57 F. Supp. 680 (D. C., E. D. Pa., 1944), 61 F. Supp. 905 (D. C., E. D. Pa., 1945); noted in 31 VA. L. R. 695 (1945).
- (6) Right of shareholder to reimbursement from corporation of expenses incurred by him:

Shareholders' suits are of two general types: (1) those in which the shareholder's interest is actually or in effect that of a creditor of the defendant corporation or officers, and (2) those in which the shareholder's interest is his eventual proportion of a claim which the corporation has as a creditor of the defendant. Each of these types of suits may be further subdivided into (a) those in which the shareholder seeks to protect only his individual interest, and (b) those in which he sues on behalf of himself and all other shareholders similarly situated.

In suits of the first type the shareholder is normally permitted to maintain an individual action for the injury to himself, personally, as a shareholder. Illustrations are where he seeks to recover his pro rata share of a declared dividend, or to enforce his pre-emptive right in a new issue of shares. In suits of this type it is only under very rare circumstances that the court will insist upon his bringing a class action in order to avoid a multiplicity of suits.

With respect to suits of the second type the shareholder is almost invariably required to institute a representative suit, and an effort to recover a personal judgment for the injury to the complainant's individual interest as a shareholder will be demurrable. The reason for this is obvious: if the wrong complained of is to the corporation, as where corporate property has been appropriated, or where a valuable right of the corporation has not been enforced, the injury is to the entire body of shareholders, and may also be to the detriment of the corporation's creditors. To permit each shareholder to recover from the defendant his proportionate interest in the corporation's claim would not only promote a multiplicity of suits, but would also result in a division of corporate assets in violation of the rules concerning such distributions to shareholders. From time to time, however, shareholders do attempt individual rather than representative suits, and occasionally courts do hold that the injury to the corporation was accompanied by a special set of facts justifying the complainant in maintaining an individual suit. A dubious example of such a ruling is to be found in the recent case of *Word v. Union Bank and Trust Co.*¹³

Bingham v. Ditzler, 320 Ill. App., 49 N. E. (2d) 812 (1943); noted in 22 CHI-KENT L. R. 159 (1944).

Hayman v. Morris *et al.*, 37 N. Y. Supp. (2d) 884 (1942); see also 179 Misc. 265, 38 N. Y. Supp. (2d) 782 (1942).

(7) Right of director to reimbursement from corporation of expenses incurred by him in successfully defending an action against him: Solimine v. Hollander *et al.*, 129 N. J. Eq. 264, 19 Atl. (2d) 344 (1941). See "Right of Directors to Reimbursement for Cost of Successfully Defending Shareholder's Derivative Suit", 40 COL. L. R. 1192 (1940).

13. *Supra*, note 12.

The opportunities of corporate officials to mulct the corporations they manage are great, and the ability of shareholders to detect such misconduct is slight. Hence one would expect that, when shareholders do occasionally undertake to challenge the conduct of their representatives, the courts would endeavor, when possible, to minimize the procedural barriers which might be used to block the shareholder's path. But unfortunately some courts do not adopt this attitude, as evidenced by a recent California decision in which the supreme court, by a 4-3 vote, arrived at an unnecessarily technical construction of the pleadings which resulted in a ruling that the shareholder's action was barred by a statute of limitations.¹⁴

The unwillingness of such a court to make an allowance for the difficulties, both as to discovery and proof, confronting shareholders who have truly been harmed by misconduct of their corporation's officers may be due to the fact that corporations are plagued by the existence of piratical gentry who from time to time institute representative suits solely with the hope of creating a nuisance value and being bought off at a fancy figure. But the courts should be constantly on the alert not to let the within-the-law blackmail which these "strike" suits represent prejudice the outlook for a bona fide representative suit in which a shareholder is sincerely endeavoring to counteract a wrong done to him and the other shareholders by one or more of the corporate officials.

A common instance of this almost hostile judicial attitude toward representative suits is to be found in the holdings of many—although probably not most—courts that the complainant not only must be a shareholder but also must have been a shareholder at the time the wrong complained of occurred. The federal courts, in order to avoid having their jurisdiction imposed upon, adopted a federal equity rule embodying this requirement.¹⁵ Some state courts have promulgated counterparts of this rule,¹⁶ and a number of decisions have adopted this principle even in the absence of any formalized rule.¹⁷

An absolute rule that a shareholder may not maintain a representative suit if he acquired his status as a shareholder after the occurrence of the wrong to the corporation of which his suit complains, is unreasonable and unnecessary. The claim which the complainant seeks to assert is an asset of the corporation, and he has just as legitimate an

14. *Bainbridge v. Stoner*, *supra*, note 3; see also *Gochenour v. George and Francis Ball Foundation*, *supra*, note 3.

15. See Federal Equity Rule 27, and annotations thereto in *Hopkins Federal Equity Rules* (1933), pp. 191 ff.

16. *E. g.*, Rule 37 of Rules of Equity Practice of Pennsylvania Supreme Court.

17. For recent cases dealing with this problem see *Goldberg v. Ball et al.*, *Klum v. Clinton Trust Co.*, and *Jepsen v. Peterson*, *supra*, note 12.

interest in endeavoring to safeguard the assets acquired by the corporation prior to his becoming a shareholder as those acquired thereafter. If the major concern of the courts which enforce the above-stated rule is to thwart those who buy into a corporation for the very purpose of instituting "strike" suits, this could be accomplished without an absolute disqualification of the holders of after-acquired shares. Shareholders who bought their shares with knowledge of the wrong complained of might well be barred from bringing representative suits; but shareholders who acquired their shares by operation of law or who purchased them in good faith without knowledge of the situation ought not to be deprived of one of the most important incidents of sharehold-ership, the privilege of instituting a representative suit, merely because they did not discover the misconduct of the defendants until after the transfer to them of their shares.

There are other procedural difficulties with which the moving shareholder must contend. For example, he must allege and prove either a prior demand upon the appropriate corporate officers to institute the action in question on behalf of the corporation, or the futility of such a demand, as where it would involve an action by the corporation against the officers themselves.¹⁸ This is a reasonable requirement, for a shareholder should not be permitted to invade the normal province of management in conducting the affairs of the corporation, unless he can affirmatively show that management is either wilfully or negligently sacrificing the corporation's interests.

A further hazard with which the petitioning shareholder may be confronted is that a prior representative suit may have been instituted by another shareholder and discontinued by settlement agreement. The New York courts have recently refused to vacate and set aside such a stipulation of discontinuance even under the following extreme circumstances: The shareholder's representative suit was against the Associated Gas and Electric Company (herein called the Debtor) as the nominal defendant and its directors as the real defendants. The latter were charged with mismanagement and waste of the corporate funds. The settlement took the form of a purchase of the complaining shareholders' shares by a wholly-owned subsidiary company of the Debtor; the price paid was approximately seven times the market value of said shares. The moneys paid in settlement as well as all the expenses of defending the action were supplied by the Debtor or its subsidiaries without any contribution or reimbursement by the individual directors who were the real defendants. A substantial percentage of the moneys received by the plaintiffs was paid to their attorneys who

18. See *Goldberg v. Ball et al.*, *supra*, note 12.

instituted the action. This was pursuant to private arrangement, the amount of the fees and disbursements not having been submitted for court approval. The stipulation of discontinuance was filed with the clerk of the court, but no court order was entered thereon, nor was the settlement submitted for approval to any of the shareholders who were not parties to the action.¹⁹

Such a settlement may constitute a "double looting" of the corporation, and ought not to preclude other shareholders, not parties thereto, from instituting some form of effective remedial action.²⁰ A practical reason for setting aside such settlements and for keeping the original representative suit alive is that the statute of limitations will frequently have run against a new action by the time the other shareholders discover the facts of discontinuance and settlement. A desirable solution would be a rule such as the Federal courts have adopted that shareholders' representative suits shall not be dismissed or compromised without the approval of the court, following notice of the proposed dismissal or compromise given to all the members of the class in such manner as the court directs.²¹

A very effective restraint upon the omnigenerous institution by a shareholder of representative suits is the fact that he is personally liable for all the costs and expenses if the action is unsuccessful. In 1941 the severity of this common law rule was greatly accentuated in New York by the enactment of an extraordinary amendment of the General Corporation law of that state. By this statute shareholders unsuccessfully instituting representative suits against corporate officers or directors could be subjected to liability not only for the costs and expenses to which a losing litigant is normally subject, but also for the attorneys' fees of the successful defendants.²² In a case decided subsequent to the enactment of this statute the legislation was held to have a valid retroactive effect, and allowances for fees and disbursements of the attorneys for the successful defendants totalling over \$43,000 were awarded.²³

No doubt the above-mentioned statute was enacted primarily, not to discourage shareholders from bringing representative suits, but to protect the judicially acquitted director from personal loss otherwise

19. This statement of facts is taken almost verbatim from the opinion of Justice Shientag in *Manufacturers Mutual Ins. Co. v. Hopson et al.*, *supra*, note 12.

20. For an excellent discussion of this problem see 50 *YALE L. J.* 1747 (1941).

21. See Rule 23 (c) of the Rules of Civil Procedure, 28 U. S. C. A. following section 723c.

22. See McKinney's Consolidated Laws of New York, Book 22, Section 61-a. This section was repealed in 1945 and is now partly covered by sections 64-67 of the New York General Corporation Law.

23. *Hayman et al. v. Morris et al.*, *supra*, note 12.

inherent in the demonstration of his innocence.²⁴ Legislation so limited would have merit, but there is little validity to the growing practice of the adoption of corporate by-laws under which directors and officers may be reimbursed by the corporation for various types of liabilities imposed upon them by adverse judgments and settlements, as well as for costs and expenses regardless of whether or not they establish their innocence of the wrongs with which they are charged.

Dividends

The significant decisions of 1940-45 with respect to dividend problems may be divided into four categories.²⁵

It is fundamental that the mere existence of corporate funds from which a dividend may lawfully be paid does not obligate the directors to declare and pay a dividend. Even with respect to preferred shares it is normally within the discretion of corporate directors to determine whether available funds shall be distributed to the shareholders in the form of a dividend or retained by the corporation. There are, however, several exceptions to this rule. The discretion of the directors may be overridden by a statute requiring dividend payments under stipulated circumstances. The articles of incorporation may, by express provision, make it mandatory upon the directors to pay dividends when surplus or net earnings are available.²⁶ A court of equity will on occasions order the payment of dividends, if it finds that, in withholding dividends, the directors have exercised their discretion arbitrarily or have acted in bad faith and oppressively.²⁷

24. See *New York Dock Co., Inc. v. McCollum*, 173 Misc. 106, 16 N. Y. Supp. (2d) 844 (1939); noted in 40 COL. L. R. 1192 (1940).

25. (1) Power of shareholder to compel declaration and payment of dividend: *O'Neill Co. v. O'Neill*, 108 Ind. App. 116, 25 N. E. (2d) 656 (1940); noted in 28 GEO. L. J. 1135 (1940), 15 IND. L. J. 575 (1940). *Crocker v. Waltham Watch Co.*, 315 Mass. 397, 53 N. E. (2d) 230 (1944); noted in 39 ILL. L. R. 90 (1944), 43 MICH. L. R. 214 (1944).

(2) The "dividend credit" theory: *Lich v. U. S. Rubber Co.*, 39 F. Supp. 675 (D. C., D. N. J., 1941); noted in 55 HARV. L. R. 678 (1942); 26 MINN. L. R. 117 (1941). *Cintas v. Amer. Car & Foundry Co.*, 131 N. J. Eq. 419, 25 Atl. (2d) 418 (1942); noted in 56 HARV. L. R. 132 (1942); *aff'd* without opinion in 132 N. J. Eq. 460, 28 Atl. (2d) 531 (1942).

(3) Right of shareholder with respect to declared dividends: *Strout v. Cross, Austin & Ireland Lumber Co.*, 258 App. Div. 1046, 18 N. Y. Supp. (2d) 996 (1940), *aff'd* 283 N. Y. 406, 28 N. E. (2d) 890 (1940); noted in 9 DUKE B. A. J. 76 (1941). *Jaques v. White Knob Copper & Development Co., Ltd.*, 19 N. Y., 19 N. Y. Supp. (2d) 706 (1940); noted in 15 ST. JOHN'S L. R. 301 (1941). Cf. *Taylor v. Axton-Fisher Tobacco Co.*, 295 Ky. 226, 173 S. W. (2d) 377 (1943).

(4) Illegal dividends: *Oilwell Chemical & Materials Co. v. Petroleum Supply Co.*, 64 Cal. App. 367, 148 Pac. (2d) 720 (1944); noted in 32 CALIF. L. R. 312 (1944).

26. See *Crocker v. Waltham Watch Co.*, *supra*, note 25.

27. See *O'Neill v. O'Neill Co.*, *supra*, note 25.

Although the latitude of directors with respect to accumulating corporate earnings by *not* declaring dividends is extremely wide, it does not follow that, when they ultimately do decide to exercise their discretion in favor of a dividend distribution of all or part of the accumulated earnings, they can completely disregard the rights which various classes of shareholders would have had if dividends had been paid from year to year as earned. There is some authority to the effect that when directors do elect to distribute dividends based upon past earnings, they must apportion such dividends among the holders of the various classes of shares in accordance with the principles which would have governed if the earnings had been distributed annually instead of accumulated. This is known as the "dividend credit theory."²⁸

The principle applications of the dividend credit theory have been in New Jersey with respect to the rights of the holders of non-cumulative preferred shares. Let us suppose that a corporation, at its inception, issues 1000 common shares and 1000 preferred shares the holders of which are entitled to a "non-cumulative" preference of \$5 per share as to dividends; that during each of the first five years of its existence the corporation has net earnings of \$10,000; and that the directors, year by year, elect to pay no dividends until the end of the fifth year by which time net earnings of \$50,000 will have accumulated. May the directors at this point lawfully pay a dividend of \$5 per share on the preferred shares, and \$45 (or some lesser amount in excess of \$5) per share on the common shares? The New Jersey courts say "no." Their reasoning is that, even where the directors have been exercising their discretion not to pay dividends in good faith, they cannot by virtue of this postponement equitably divert to the common shares earnings which otherwise would necessarily have gone to the non-cumulative preferred. Under this theory non-cumulative preferred shares differ from cumulative preferred shares in that the former acquire no claim to dividend payments with respect to years in which the preference is not earned; but to the extent that the amount of the preference is earned, a credit accrues to such preferred shares which must be satisfied, before dividends may thereafter be paid on the common shares.

In applying the dividend credit rule it becomes important to determine annually the fund lawfully available for dividends, as the "credits" arise only with respect to such fund. In 1941 the federal district court in New Jersey decided that a credit does not accrue with respect to

28. For an extensive discussion of this theory, see my article, *The Distribution of Corporate Dividends*, 89 U. OF PA. L. R. 735 (1941) at pages 750-763.

annual net earnings if such earnings are insufficient to offset a capital impairment resulting from operating losses in prior years.²⁹ The following year the New Jersey courts held that, for the purpose of determining dividend credits of shareholders in a corporation with many subsidiaries, the annual net earnings should not be based upon a consolidated statement of all of the companies but should be confined to the net income of the parent corporation, including therein dividends received by the parent company from its subsidiaries during a given fiscal year regardless of whether the subsidiaries had earned the dividends in the year in which they were paid or in prior years.³⁰ This refusal to pierce the corporate veil was favorable to the shareholders claiming dividend credits. In 1936, for example, the corporation would have had a deficit of over \$1,000,000 (and hence no dividend credit would have arisen for that year), if it had not received close to \$5,000,000 in dividends from its subsidiaries. The corporation contended that the dividends paid to it by its subsidiaries in 1936 exceeded the earnings of the subsidiaries for that year, and that to the extent that the dividends were paid out of earnings of the subsidiaries of previous years, they ought not to be included as part of the parent company's net earnings for 1936. This contention would be correct if the parent company and its subsidiaries were regarded as comprising a single unit or enterprise, a conclusion which for this purpose the court refused to accept.

It is frequently stated by courts and text-writers that if the directors of a corporation declare a dividend and communicate their action to the shareholders, the latter thereby become "creditors" of the corporation to the extent of the declared dividend. This is not a strictly accurate concept for, although there is some authority to the contrary, shareholders should not be permitted to extract funds from the corporation to the detriment of its real creditors, if the surplus upon which the dividend declaration was premised becomes, or is discovered to have been, non-existent after the declaration of the dividend but before payment. A preferable analysis of the effect of a communicated dividend declaration is that the directors have thereby exercised their discretion as to the distribution of the necessary funds to the shareholders in the form of a dividend. Hence such a declaration should be irrevocable, and should be operative if, or even when, the funds are available. But the directors do not have discretion to sanction dividend payments which the law forbids, and therefore the declaration should create immediate rights in the shareholders only when the required funds are lawfully available. Accordingly, the position of a

29. See *Lich v. U. S. Rubber Co.*, *supra*, note 25.

30. See *Cintas v. American Car & Foundry Co.*, *supra*, note 25.

shareholder with respect to a declared dividend is materially different from that of a "creditor," whose right to payment of the debt due him is unqualified and who may even have recourse to bankruptcy proceedings if payment is not made when due.

This erroneous concept of a shareholder as a "creditor" of his own corporation with respect to a declared dividend recently led the New York courts to reach a conclusion adverse to the shareholder's interest. In 1906 H. C. Lloyd became shareholder of record of one hundred preferred shares in the defendant corporation. Sometime between 1906 and 1913 he transferred the shares to one Jaques, apparently by a transfer of the endorsed certificate, but this transfer was not recorded on the corporate books. In 1913 Jaques died and the certificate was turned over to his son, Thomas L. Jaques. The latter retained the certificate in his vault up to the time of his death in 1931. Between 1914 and 1922 various dividends were declared on these shares but not paid (though received by other shareholders), because the corporation could not locate H. C. Lloyd; it did not become aware until 1938 that the shares had been transferred by him. In an action by the executor of Thomas L. Jaques (who was owner of the shares at the time of the dividends in question) to recover the dividends, the court gave judgment for the defendant corporation on the ground that the shareholder had become a creditor by virtue of the dividend declarations and that as such his claim was barred by the running of the applicable statute of limitations.³¹ This is an unfortunate decision. It may well be that if a shareholder omits for an unreasonably long interval to collect the dividends to which he is entitled, the corporation should be upheld in resisting ultimate payment if it can show that his lack of diligence resulted in hardship to the corporation. But automatically to deprive him of his share of the corporate profits by superimposing a statute of limitations upon a dubious "creditor" concept smacks of mechanical jurisprudence.

Amendments to Articles of Incorporation

The significant war-time decisions involving "charter" amendments deal with the rights of dissenting shareholders in three types of circumstances.³²

31. See *Jaques v. White Knob Copper & Development Co., Ltd.*, *supra*, note 25.

32. (1) Creation of prior preference shares:

Johnson v. Fuller et al., 36 F. Supp. 744 (D. C., E. D. Pa., 1940), *aff'd* 121 F. (2d) 618 (C. C. A. 3d, 1941); noted in 8 U. Prrt. L. R. 76 (1941), 27 VA. L. R. 954 (1941).

Shanik v. White Sewing Machine Corp., 15 Atl. (2d) 169 (Del., 1940), *aff'd* 19 Atl. (2d) 831 (Del., 1941); noted in 7 U. OF Prrt. L. R. 326 (1941).

When a corporation has several classes of shares outstanding, situations may develop that give rise to a desire to reorganize its share structure. The real motive may be a concealed effort by common shareholders to improve their opportunities for profit by curtailing the superior claims on earnings previously accorded to preferred shareholders. On the other hand, the actual explanation may be that the corporation is in need of new capital which cannot be secured unless (a) authorized but unissued common shares are rendered more attractive by whittling away some of the preferential or other rights of the extant preferred shares, or (b) provision is made for the issuance of a new class of preferred shares which will have priority over the existing preferred shares, or (c) a combination of both.

In a number of states the general incorporation act has been amended so as expressly to authorize charter amendments which reclassify the authorized capital stock by changing "preferences, or relative, participating, optional or other special rights of the shares." Some of these statutes indicate circumstances under which a dissenting shareholder shall have a right to be bought out, i. e., to receive from the corporation the value of his shares, to be determined by appraisers if a price cannot be agreed upon.

When a corporation amends its articles so as to create new preferred shares having priority over the old preferred shares, the value of the old preferred shares may be thereby substantially diminished. But if the reorganization does not directly destroy any of the incidents of the old preferred shares or alter their relative position with respect to the common or other junior shares, actions by dissenters to nullify the new prior preferred shares or to restrain the payment of dividends thereon are usually unsuccessful.

But charter amendments which purport directly to alter or eliminate some of the attributes of the existing shares have in a number of

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- Kreicker v. Naylor Pipe Co., 374 Ill. 364, 29 N. E. (2d) 502 (1940); noted in 8 U. CHI. L. R. 134 (1940).
- (2) Elimination of sinking fund requirement:
 Davison v. Parke, Austin and Lipscomb, 173 Misc. 782, 19 N. Y. Supp. (2d) 117 (1940), *aff'd* 260 App. Div. 860, 23 N. Y. Supp. (2d) 557 (1940), *rev'd* 285 N. Y. 500, 35 N. E. (2d) 618 (1941); noted in 26 MINN. L. R. 387 (1942), 19 N. Y. U. L. Q. 196 (1942).
 Wildermuth v. Lorain Coal Co., 138 Ohio St. 1, 32 N. E. (2d) 413 (1941). *aff'd* 37 N. E. (2d) 201 (Ohio App., 1940); noted in 7 OHIO ST. L. J. 241 (1941), 8 OHIO ST. L. J. 100 (1941).
- (3) Cancellation of accumulated preferential dividends:
 McNulty v. W. & J. Sloane, 54 N. Y. Supp. (2d) 253 (1945).
 Davison v. Parke, Austin and Lipscomb, *supra*.
 Harbine v. Dayton Malleable Iron Co., 61 Ohio App. 1, 22 N. E. (2d) 281 (1939); noted in 6 OHIO ST. L. J. 313 (1940), 25 CORN. L. Q. 431 (1940).
 Cf. Goldman v. Postal Telegraph, Inc., 52 F. Supp. 763 (D. C., D. Del., 1943) and Jay Ronald Co., Inc. v. Marshall Mortgage Corp. *et al.*, 265 App. Div. 622, 40 N. Y. Supp. (2d) 391 (1943).

instances been successfully attacked, if the court concludes that the affected shareholders are being deprived of "vested rights." In the absence of a permissive statute there is grave doubt as to the power of the majority of the shareholders to alter in any material way the so-called "contract" between a given class of shareholders and the corporation or between the shareholders inter se without the consent of those affected. But even under the theory of the reserved power of the state to alter, amend or repeal corporate charters, there are at least two respects in which permissive statutes, however broadly expressed, are generally held by the courts not to validate charter amendments purporting to destroy rights of preferred shareholders. These are the right to the benefit of sinking fund provisions for the retirement or redemption of preferred shares, and the right of holders of cumulative preferred shares to receive unpaid back dividends before any dividends may be paid on common or other junior shares. This so-called "vested right" is especially important in those jurisdictions in which a shareholder who dissents to such charter amendments is not granted a right to the appraisal value of his shares. But even in such jurisdictions the "right" of a shareholder to retain his interest in accumulated dividends has been rendered virtually worthless by recent decisions of the very courts which proclaimed the "vested right" doctrine. The Delaware courts, for example, uphold the validity of a charter amendment creating a class of prior preferred shares upon which dividends may be paid before the dividend arrearages accumulated on the old preferred shares have been paid up. Confronted by such economic pressure the old preferred shareholders may have no practical alternative to acceptance of the proffered new securities in exchange for their old shares and cancellation of the accrued dividends. Moreover, Delaware has lately approved a device whereby this alleged "vested right" can be completely eliminated without a charter amendment, namely, by merger with a wholly owned subsidiary. This development is discussed in the following division of this article.

Corporate Combinations by Merger or Sale of Assets

There are four principal topics involved in the significant wartime cases arising out of mergers or sales of the assets of one corporation to another.³³

33. (1) Merger or sale of assets as a device for eliminating unpaid dividends on cumulative preferred shares:
 Hottenstein v. York Ice Machine Corp., 45 F. Supp. 436 (D. C., D. Del., 1942), *aff'd* 136 F. (2d) 944 (C. C. A. 3d, 1943); noted in 43 COL. L. R. 230 (1943), 29 CORN. L. Q. 114 (1943).
 Federal United Corporation v. Havender, 23 Del. Ch. 104, 2 Atl. (2d) 143 (1938), 6 Atl. (2d) 618 (Del., 1939), *rev'd* 11 Atl. (2d) 331 (Del.,

In the well-known cases of *Keller v. Wilson & Co.*³⁴ and *Consolidated Film Industries v. Johnson*³⁵ the supreme court of Delaware established the doctrine that a holder of cumulative preferred shares had a "vested right" to back dividends of which he could not be deprived by an amendment to the corporation's certificate of incorporation. In the recent case of *Federal United Corp. v. Havender*³⁶ the same court³⁷ held that the right of preferred shareholders to receive in cash dividends accumulated on their preferred shares could lawfully be extinguished by a reclassification of the share structure pursuant to a merger of the corporation with a wholly-owned, inactive subsidiary. This series of decisions evoked the following comment from Judge Biggs in his opinion in the case of *Hottenstein v. York Ice Machinery Corporation*:³⁸ "If it is fair to say that the decision of the Supreme Court of Delaware in the *Keller* case astonished the corporate world, it is just to state that the decision of the Supreme Court in *Havender* astounded it, for shorn of rationalization the decision constitutes a repudiation of principles enunciated in the *Keller* case and in *Consolidated Film Industries v. Johnson*, supra." Later in his opinion (at page 951) Judge Biggs observed that "we must conclude that *Havender* broke *Keller's* back."

The facts in the *Hottenstein* case were practically identical with those in the *Havender* case except that in the former case the wholly-

1939); noted in 24 MINN. L. R. 992 (1940), 25 WASH. L. Q. 614 (1940). *Porges v. Vadsco Sales Corp.*, 32 Atl. (2d) 148 (Del., 1943); noted in 42 MICH. L. R. 332 (1943).

Zobel v. American Locomotive Co., 182 Misc. 323, 44 N. Y. Supp. (2d) 33 (1943).

Craddock-Terry Co. et al. v. Powell et al., 181 Va. 417, 25 S. E. (2d) 363 (1943).

- (2) Power of shareholder to enjoin unfair plans:

Klopot v. Northrup, 131 Conn. 14, 37 Atl. (2d) 700 (1944); noted in 43 MICH. L. R. 421 (1944).

Porges v. Vadsco Sales Corp., 32 Atl. (2d) 148 (Del., 1943); noted in 42 MICH. L. R. 332 (1943).

- (3) Right of dissenters to appraisal value:

Salt Dome Oil Corp. v. Schenck, 41 Atl. (2d) 583 (Del., 1945); noted in 31 VA. L. R. 698 (1945).

Bishop & Babcock Co. v. Fuller, 43 N. E. (2d) 638 (Ohio, 1941); noted in 21 CHI-KENT L. R. 192 (1943).

Voeller v. Neilston Warehouse Co., 136 Ohio St. 427, 26 N. E. (2d) 442 (1940), *rev'd* 311 U. S. 531, 61 Sup. Ct. 376 (1940); noted in 38 MICH. L. R. 1165 (1940), 27 VA. L. R. 390 (1941).

- (4) Power of voting trust trustees to authorize sale of assets:

Application of Bacon et al., 262 App. Div. 818, 28 N. Y. Supp. (2d) 122 (1941), *aff'd* 287 N. Y. 1, 38 N. E. (2d) 105 (1941); noted in 55 HARV. L. R. 868 (1942).

34. 21 Del. Ch. 391, 190 Atl. 115 (1936).

35. 22 Del. Ch. 407, 197 Atl. 489 (1937).

36. *Supra*, note 33.

37. The *Wilson* case was decided by Chief Justice Layton and Associate Judges Richards, Speakman and Harrington. The *Havender* case was decided by Chief Justice Layton and Associate Judges Richards, Speakman and Rodney.

38. *Supra*, note 33, at page 950.

owned, inactive subsidiary utilized to consummate the merger was created for this very purpose, and the surviving corporation was the subsidiary, whereas in the *Havender* case the survivor was the corporation of which the plaintiff was a preferred shareholder. The Circuit Court did not regard either of these circumstances as a justifiable basis for distinguishing the two cases, and under the Rule in *Erie R. R. Co. v. Tompkins*³⁹ the court interpreted the law of Delaware as authorizing the merger in question together with its concomitant effect of destroying the plaintiff's interest in accumulated dividends on his preferred shares in the absorbed parent corporation.

A case arose recently in Virginia in which a corporation sought to use a transaction akin to merger as a device to eliminate accumulated dividends in arrears. Not being permitted to amend its charter for this purpose, the corporation resorted to a Virginia statute authorizing a corporation to sell all of its assets with the consent of two-thirds of the outstanding shares to another corporation in return for shares in the purchasing corporation. The corporation caused a new corporation to be created with substantially the same name and with the same officers and directors as the old corporation, transferred all of its assets to this new corporation in exchange for stipulated numbers and classes of shares in the new corporation, which shares, with the consent of over eighty per cent of the old shareholders, were delivered to them by the new corporation pursuant to the terms of the sale plan upon surrender of their old shares. The plaintiff dissented and sought to enforce his rights to accumulated dividends and to the retirement value of his shares in accordance with the provisions of the charter of the old corporation. The supreme court of Virginia held that the plaintiff was entitled to recover the par value of his preferred shares with interest from the date the old corporation transferred its assets to the new corporation. But the decision was by only a 4-3 majority, and the dissenters strenuously urged that the sale statute entitled the plaintiff preferred shareholder only to the "fair cash value" of his shares, which would have included no allowance for accumulated dividends. One may predict that statutory authorization of a sale of all the assets for shares with less than unanimous consent will soon be accepted by the courts as a companion device to that of merger for cancelling hitherto "vested rights" of dissenting preferred shareholders.

Even where a dissenting shareholder has a statutory right to the value of his shares upon a merger or sale of all the assets, his path through some courts is hazardous. Delaware has held, for example, that dissenters who were unquestionably shareholders but not "of rec-

39. 304 U. S. 64, 58 Sup. Ct. 817, 82 L. Ed. 1188 (1938).

ord" are not entitled to the appraisal value of their shares provided for in the merger statute;⁴⁰ and Ohio recently ruled that a shareholder, who dissented from a sale of all his corporation's assets, and who thereafter sold 25 of his shares and repurchased another 25 shares from a fellow dissenter, could not claim the benefit of the statute with respect to the 25 shares in question.⁴¹

Termination of the Corporate Enterprise

The termination of a corporation's existence may be voluntary or involuntary. Voluntary dissolution is a statutory process and is founded upon the consent of the requisite majority of the shareholders. But liquidation and winding up may, under appropriate circumstances, be enforced by holders of a minority share interest. Furthermore, corporate existence may terminate by expiration of the period of incorporation, or be terminated by bankruptcy proceedings. Moreover, a corporation's charter may be forfeited as a prescribed penalty for non-compliance with stipulated requirements of the state of incorporation. Only the first and the last of these enumerated types of "termination" are involved in the significant cases of 1940-1945.⁴²

The older cases and texts seem to have regarded dissolution or forfeiture of a corporation's charter as equivalent to the death of a natural person, thereby effecting an immediate and complete termination of all corporate attributes. But the analogy is most imperfect, and modern courts have come to recognize that this "termination" is

40. Salt Dome Oil Corp. v. Schenck, *supra*, note 33.

41. Bishop & Babcock Co. v. Fuller, *supra*, note 33.

42. (1) Voluntary dissolution:

a. Duty of alleged successor corporation:

N. L. R. B. v. Tulpelo Garment Co., 122 F. (2d) 603 (C. C. A. 5th, 1941); noted in 48 W. VA. L. Q. 168 (1942).

b. Rights of dissenting minority shareholders:

Lebold *et al.* v. Inland Steel Co., 125 F. (2d) 369 (C. C. A. 7th, 1941), *cert. denied* 316 U. S. 375, 62 Sup. Ct. 1049, 86 L. Ed. 1749 (1942); noted in 10 U. CHI. L. R. 77 (1942), 28 VA. L. R. 1132 (1942).

(2) Forfeiture of corporation's charter:

a. Survival of corporation for procedural purposes:

Peoria Coal Co. v. Ashcraft *et al.*, 123 W. Va. 586, 17 S. E. (2d) 444 (1941); noted in 48 W. VA. L. Q. 284 (1942). Missouri *ex rel.* Darr v. A. B. Collins & Co., 34 F. Supp. 549 (D. C., Mo., 1940). Missouri *ex rel.* Darr v. A. B. Collins & Co., 34 F. Supp. 550 (D. C., Mo., 1940); noted in 29 GEO. L. J. 511 (1941), 25 MINN. L. R. 512 (1941).

b. Corporate powers subsequent to termination:

McNeil v. Savin, 246 Wis. 552, 13 N. W. (2d) 82 (1944); noted in 44 CHI-KENT L. R. 287 (1944). *In re* Columbia Hotel, 29 F. Supp. 848 (D. C., W. D. Mich., 1939), *rev'd* 109 F. (2d) 1013 (C. C. A. 6th, 1940); noted in 38 MICH. L. R. 220 (1940). Cf. Watts v. Liberty Royalties Corp., 106 F. (2d) 941 (C. C. A. 10th, 1939), and Association Collectors v. Hardman, 2 Wash. (2d) 414, 98 Pac. (2d) 318 (1940).

primarily prospective. Frequently, events technically described as a termination of the corporation's existence happen before the business enterprise has been liquidated and wound up. The legal consequences of "termination" may very well be that no future activities may be lawfully undertaken in corporate form which are unrelated to the process of winding up the enterprise; but today courts will permit transactions, including litigation, in the corporate name to the extent that this facilitates a just and prompt settlement of the affairs of the "terminated" corporation.

This is especially true when the "termination" results not from compliance with the statutory process for obtaining a certificate of dissolution but from "forfeiture" or "cancellation" of the corporation's charter by action of a state official for failure to pay taxes or fees or to file reports required by statute. For example, it has been held that proceedings to reorganize a corporation under section 77B of the federal bankruptcy act might be instituted six years after the governor of the state of incorporation had proclaimed the cancellation of the corporation's charter for non-payment of required license fees.⁴³ A corporation was allowed to continue its action to cancel a quit-claim deed despite the defendant's plea in abatement filed after the corporation's charter had been declared forfeited for tax delinquency.⁴⁴ Likewise the appointment of a receiver for a corporation was upheld, although the receivership petition was not filed until after the Attorney General of the state of incorporation had obtained a decree dissolving the corporation.⁴⁵ The federal district court in Missouri has been faced with the interesting question as to whether a corporation, whose charter has been declared forfeited by the secretary of state for failure to file the required annual registration report and anti-trust affidavit, continues to be a "citizen" of the state of incorporation for the purpose of determining whether an action by a resident of Missouri against the "terminated" Missouri corporation and a foreign corporation can be removed to the federal court, on the ground of diversity of citizenship, after the charter forfeiture. In companion cases, two district court judges rendered opposite decisions.⁴⁶

The authorities are in conflict as to whether the power to dissolve a corporation given by statute to a designated majority of the shareholders is absolute, or whether it can be restrained by action of the minority if exercised from improper motives. The better view is that the majority do owe a responsibility to the minority to exercise their

43. *Watts v. Liberty Royalties Corp.*, *supra*, note 42.

44. *Peoria Coal Co. v. Ashcraft et al.*, *supra*, note 42.

45. *McNeil v. Savin*, *supra*, note 42.

46. *Missouri ex rel. Darr v. A. B. Collins & Co.*, *supra*, note 42.

controlling power with reasonable regard for the interests of the minority. This was recently illustrated by a significant decision of the federal court of appeals for the seventh circuit.⁴⁷ The Inland Steel Company owned over eighty per cent of the shares of the Inland Steamship Company. The Steamship company was engaged in a very profitable business of transporting ore, the Steel Company being its principal if not its only customer. Indeed, on March 18, 1936 the Steamship company declared an annual dividend of \$150.00 per share. Eight days thereafter a special meeting of the Steamship shareholders was called for the purpose of considering the dissolution of the company. At the meeting Inland Steel voted its majority stock in favor of dissolution of Inland Steamship, and a resolution to this effect was adopted over the negative votes of the plaintiffs and other minority shareholders. Less than a month later the directors of Steamship (all of whom were also executive officers of Steel) sold the three boats to Steel for their fair value. Steel immediately proceeded to operate the boats in the same business formerly conducted by Steamship. The proceeds of this sale were distributed pro rata to Steamship's shareholders, including the plaintiffs. The action of the plaintiffs is not to rescind the dissolution and sale but to recover from Steel a money judgment for damages incurred by Steel's alleged fraud in dissolving the steamship company, buying its assets, and appropriating its business. In deciding in favor of the plaintiffs the court said (pages 372-3): "The vote of every director and of every majority stockholder must be directed to and controlled by the guiding question of what is best for the corporation, for which he is, to all legal intents and purposes, trustee. . . . The so-called dissolution was a mere device by means of which defendant appropriated for itself the transportation business of the Steamship Company to the detriment of plaintiffs. That the source of this power is found in a statute, supplies no reason for clothing it with a superior sanctity, or vesting it with the attributes of tyranny." In assessing the damages to which plaintiffs were entitled, the court's ultimate finding was that each share in the Steamship Company had a value of \$1350 at the time of the dissolution and sale.

Miscellaneous Matters

In addition to the larger divisions of the law of private corporations heretofore indicated, the significant recent cases dealt with a miscellany of topics which there is neither time nor space to discuss in detail.

47. *Lebold et al. v. Inland Steel Co.*, *supra*, note 42.

Seven cases concerned *the right to examine corporate records*.⁴⁸ The common law rule generally enunciated is that a shareholder has a right to examine the books and records of his corporation at any reasonable time and for any proper purpose. There seems to be some doubt as to whether, in case of refusal of his demand, the burden is on the shareholder to prove a proper purpose or on the corporation to prove an improper purpose. From a practical standpoint the burden would appear to be that of the corporation, as the shareholder need only allege that he desired to determine the value of his shares or to ascertain whether the corporation had been properly managed. There are statutes in many states dealing with this right of inspection and under such statutes issues frequently arise as to whether the statutory right is absolute or merely a codification of the common law rule. In general the courts are much more liberal in extending the right of examination of corporate records to directors than to shareholders, though even here the right is not absolute if it can be shown that the motive of the director is antagonistic to the interests of the corporation. Some courts have recognized holders of voting trust certificates as having a right similar to that of shareholders to examine the corporation's records. This problem has been expressly covered by statute in some states. The usual procedure for enforcing the right of examination is a writ of mandamus.

Problems concerning *the power to elect directors* were involved in seven cases.⁴⁹ In the absence of a statute or provision of the articles

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48. (1) Statutory right of shareholders:
Morris v. Broadview, 385 Ill. App. 228, 52 N. E. (2d) 769 (1944); noted in 22 CHI-KENT L. R. 201 (1944). *Flowers v. Rotary Printing Co.*, 65 Ohio App. 543, 31 N. E. (2d) 251 (1940); noted in 8 OHIO ST. L. J. 204 (1942). *Pick v. Wesbar Stamping Corp.*, 238 Wis. 93, 298 N. W. 58 (1941); noted in 1942 WIS. L. R. 292. Cf. *Cornell v. Nestle Le Mur Co.*, 65 Ohio App. 1, 29 N. E. (2d) 162 (1940); noted in 7 OHIO ST. L. J. 75 (1940).
 - (2) Right of directors:
Drake v. Newton Amusement Corp., 123 N. J. L. 560, 9 Atl. (2d) 636 (1939); noted in 28 GEO. L. J. 1133 (1940). *Dandini v. Superior Court*, 38 Calif. App. (2d) 32, 100 Pac. (2d) 535 (1940); noted in 28 CALIF. L. R. 636 (1940).
 - (3) Right of voting trust certificate holder:
Brentmore Estates, Inc. v. Hotel Barbizon, 177 Misc. 11, 29 N. Y. Supp. (2d) 830 (1941), 263 App. Div. 389, 33 N. Y. Supp. (2d) 331 (1942); noted in 56 HARV. L. R. 133 (1942).
 49. (1) Eligibility of voters:
 - a. Shareholder of record after unrecorded transfer of his shares:
In re Giant Portland Cement Co., 21 Atl. (2d) 697 (Del., 1940); noted in 40 MICH. L. R. 588 (1942).
 - b. Pledgor:
Lawrence v. Parlier Estate Corp., 92 Pac. (2d) 917 (Calif., 1939), *rev'd* 15 Calif. (2d) 220, 100 Pac. (2d) 965 (1940); noted in 29 CALIF. L. R. 424 (1941).
 - c. Voting trust trustee:
Friedberg v. Schultz et al., 312 Ill. App. 171, 38 N. E. (2d) 182 (1941); noted in 20 CHI-KENT L. R. 269 (1942), 41 MICH. L. R. 166 (1942).

or by-laws to the contrary, the actual shareholder, even though unrecorded on the corporate records, is entitled to vote at shareholders' meetings. However, in the absence of actual knowledge of an unrecorded transfer, the corporation will be upheld if it allows the "shareholder of record" to vote. The modern practice is to limit voting rights to shareholders of record as of a designated day prior to the meeting; a provision to this effect is usually set forth in the articles or by-laws. But even though only shareholders of record on the designated date may vote, it does not follow that the corporation should be upheld in permitting all such persons to vote, especially in the case of a close corporation, if it has actual knowledge that the shareholder of record had transferred his ownership prior to the record date.⁵⁰ The supreme court of Pennsylvania has recently construed a Pennsylvania statute as precluding the voting of fractional shares at a meeting of shareholders for the election of directors.⁵¹ Pre-emptive rights have an intimate relationship to the election of directors, for denial of a shareholder's pre-emptive right to subscribe proportionately for a new issue of voting shares will adversely affect his percentage of voting control.

Transactions of *corporate promoters* are involved in three of the cases.⁵² Four cases relate to *the authority of the president* of a corporation.⁵³

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- Rittenberg v. Murnighan, 381 Ill. 267, 44 N. E. (2d) 913 (1942); noted in 32 ILL. B. J. 127 (1943).
- d. Holder of fractional share:
Commonwealth v. Cartwright, 350 Pa. 638, 40 Atl. (2d) 30 (1944); noted in 43 MICH. L. R. 986 (1945), 93 U. OF PA. L. R. 321 (1945).
- (2) Validity of notice of shareholders' meeting:
Boericke v. Weise, 68 Cal. App. (2d) 405, 156 Pac. (2d) 781 (1945); noted in 33 CALIF. L. R. 321 (1945).
- (3) Pre-emptive rights:
Heylandt Sales Co. v. Welding Gas Products Co., 180 Tenn. 437, 175 S. W. (2d) 557 (1943); noted in 18 TENN. L. R. 716 (1945).
50. See Laurence v. Parlier Estate Corp., *supra*, note 49.
51. Commonwealth v. Cartwright, *supra*, note 49.
52. (1) Promoters' profits:
Jeffs v. Utah Power & Light Co., 136 Me. 454, 12 Atl. (2d) 592 (1940); noted in 54 HARV. L. R. 139 (1940), 19 TEX. L. R. 198 (1941).
- (2) Promotor's personal liability on pre-incorporation transaction:
Johnson & Carlson v. Montreuil's Estate, 291 Mich. 582, 289 N. W. 262 (1939). Cf. African Metals Corp. v. Bulova, 288 N. Y. 78, 41 N. E. (2d) 466 (1942); noted in 28 CORN. L. Q. 93 (1942).
53. (1) Authority to engage legal service for corporation:
Kelly v. Citizens' Finance Co., 306 Mass. 531, 28 N. E. (2d) 1005 (1940); noted in 29 CALIF. L. R. 422 (1941), 89 U. OF PA. L. R. 386 (1941).
- (2) Authority to endorse corporate check:
Sam R. Levy Fabrics, Inc. v. Shapiro Bros., 259 App. Div. 463, 19 N. Y. Supp. (2d) 593 (1940); noted in 15 ST. JOHN'S L. R. 100 (1940).
- (3) Authority to execute corporate promissory note:
Italo-Petroleum Corp. v. Hannigan, 40 Del. 534, 14 Atl. (2d) 401 (1940); noted in 29 GEO. L. J. 782 (1941), 50 YALE L. J. 348 (1940).
- (4) Authority to execute corporate mortgage:
In re Henry Harrison Co., Inc., 40 F. Supp. 733 (D. C., W. D. N. Y., 1941); noted in 30 GEO. L. J. 309 (1942).

Five of the cases present efforts to "*pierce the corporate veil*."⁵⁴ In two of these five cases, the corporate veil was pierced, and in the other three the identity of the corporation as an entity separate from its shareholders was maintained. But it is interesting to note that in two of the latter three cases the decision was adverse to the corporation, as it was the party seeking to establish that the parent corporation and its subsidiary were in reality one. In one of these two cases a transfer of property by a subsidiary company to its parent corporation was held to be subject to a retail sales tax, despite an effort to show that the transaction was not a sale because the two corporations were so interrelated that they should be regarded as one; in the other case a coal producing company which sold its entire product to a railroad which owned all of its stock was held to be subject to the provisions of the Bituminous Coal Act, despite the contention that it should be exempted on the ground that the producer and consumer were really the same entity.

Conclusion

A survey of the cases upon which this article is based reveals that there is today one dominant problem in the realm of private corporations with which the courts are constantly being confronted, namely, the relationship between a corporation's managers and its shareholders. Certainly in former times the prevalent conception was that the shareholders were the owners of the business, and that the directors and executive officers were their representatives, acting on their behalf, not exactly as "agents" but in much the same manner that members of a legislature act for and represent the best interests of their constituents. For years there has been a gradual evolution in the nature of this relationship, especially in the case of large corporations where no direct "control" by the shareholders is practicable. One senses that corporate managers, largely freed from control and effective accountability, have come to regard themselves as "it," the corporation, and the shareholders as mere investors for whom they need show even less concern than for bondholders.

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54. (1) Tax liability:
Superior Coal Co. v. Dept. of Finance, 377 Ill. 282, 36 N. E. (2d) 354 (1941); noted in 22 B. U. L. R. 127 (1942), 30 Geo. L. J. 90 (1941).
H. A. S. Loan Service v. McColgan, 21 Calif. (2d) 518, 133 Pac. (2d) 391 (1943); noted in 31 CALIF. L. R. 426 (1943).
- (2) Creditor status:
Franklin Process Co. v. Western Franklin Process Co., 308 Ill. App. 302 (1941), 31 N. E. (2d) 364 (1941); noted in 36 ILL. L. R. 229 (1941).
- (3) Dower right:
Telis v. Telis, 132 N. J. Eq. 25, 26 Atl. (2d) 249 (1942); noted in 28 CORN. L. Q. 84 (1942), 41 MICH. L. R. 529 (1942).
- (4) Applicability of Bituminous Coal Act:
Keystone Mining Co. v. Gray, 120 F. (2d) 1 (C. C. A. 3d, 1941); noted in 55 HARV. L. R. 140 (1941), 90 U. OF PA. L. R. 219 (1941).

The significant cases of the past five or six years would seem to bear out this conclusion. Here are some of the illustrations: managers divert corporate earnings to themselves and away from the shareholders by arranging for huge bonuses for themselves; they appropriate corporate property to their own use, as if it were their own; they issue to themselves shares to which at common law the shareholders would have pre-emptive rights; they utilize their corporate contacts for personal profit for themselves; they resist attempts by the shareholders to examine the corporate records; they reimburse themselves from funds of the corporation for judgments obtained against them personally; they retain excessive amounts of the corporation's profits in the business instead of distributing them to the shareholders; they manipulate dividend payments so as to favor some classes of shareholders at the expense of others; and finally, if a crisis develops in the affairs of the corporation, they bring about a "reorganization" in a manner at times suggesting more concern for keeping the business, and hence their jobs and powers, alive than for the interests of the respective classes of shareholders.

Meanwhile, the development of the common law of corporations has not been keeping pace with the rapid changes which have been occurring in the size and scope and structure of private corporations. Even during the few years covered by this article, the courts were called upon to examine the relationship of corporate shareholders to corporation managers in an impressive array of large, nationally known businesses such as the American Car & Foundry Company, Associated Gas & Electric Company, Budd Manufacturing Company, Curtis Publishing Company, General Motors Corporation, Inland Steel Company, the Insull Utilities, Inc., the Pennsylvania Railroad, United States Rubber Company, Waltham Watch Company, and others.

Apart from statutory developments such as the federal Securities and Exchange Act, there are no effective restrictions on the managers of large, complex business enterprises. Almost the only method known to the common law whereby shareholders may seek a clarification or adjustment of their relationship to the directors and officers is the shareholders' representative suit. This is at best an expensive and cumbersome procedure, and the hostility to the "strike" suit which courts have generated has rendered it even less effective. If incorporated capitalism is to survive in this country, there should be a constant expansion in the ranks of shareholders, and the little shareholder should have his interests protected to the same extent as the large and affluent shareholder.

In addition to adequate machinery for quickly and inexpensively enforcing the responsibilities arising out of the shareholder-manager relationship, there is an urgent need for an authoritative analysis and statement of the functions and moral or ethical standards of the managers of modern corporations. It is my conviction that very few of those who control huge corporations have any definite personal philosophy as to the exercise of the tremendous power they wield. Most of them, I am sure, would concede that their responsibilities are not confined to themselves and the shareholders—that the interests of creditors, employees and even the public are proper objects of their concern. But when these numerous interests conflict, and vital decisions must be made, there are no generally understood and accepted guides for them to follow. Perhaps an organization like the American Law Institute could assemble a group of outstanding business men and law men who together could work out a set of fundamental principles, with comments and illustrations, which would at least be very influential with law-makers and with the courts in determining the standards to which corporate managers should be held. Chief Justice Stone once commented, with reference to the members of the Supreme Court, that in the last analysis they were subject to no restraint save self-restraint. To a very great extent this is also true of corporate managers, and their need for a set of guiding principles is urgent.